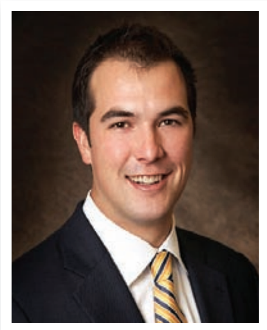
More (Financial) Stress to Come

What to expect in the next 18 months

John Simons and Eric Haley, Corporate Fuel Advisors


Eric Haley


John Simons

The flavor and fragrance industry has undergone enormous stress over the last few years. Increased regulatory obligations, whipsawing prices of raw materials, intense competition, notable litigation liabilities and the wrenching effects of the recession have, in some respects, hobbled the industry. Given the hopeful economic news regarding advances in consumer spending and retail sales, many imagine that the intense difficulties of the last four years are due to lessen and the sun is going to shine once again. Unfortunately, different, equally intense challenges will remain, and structural problems will continue to make the business climate stormy.

In our experience, through advising companies across many industries as part of an investment banking firm, we believe no single industry is more challenging than the flavor and fragrance industry. Look back at the last several years and imagine the challenges that leaders in the industry were required to face. The issues mentioned above, along with the fixed cost nature of a manufacturing or distribution platform, have caused many companies to experience a diminishing cash flow. These diminished cash flows are a result of operating losses or further restrictions in available capital. That is, few mid-sized flavor and fragrance manufacturing or distribution companies were able to weather the last few years without experiencing a loss on operations. This alone could make things hard, but when coupled with the contraction in bank lending available to support operations, there are particular segments of the industry that have been brought to their knees.

Take, for instance, the companies that warehouse and distribute ingredients to flavor and/or fragrance manufacturers, acting as intermediaries for essential oils and chemicals. Their business model is one where they stock inventories, take part in modest blending activities, and distribute product to a myriad of companies, realizing a relatively small gross margin (20%). Typically, these companies rely heavily on borrowing from banks to support inventory and receivable levels. Increased regulation has burdened these companies with additional overhead costs, and the spike in raw material pricing in mid-2008 caught many by surprise. Competition kept pricing from adjusting in equal measure. Now, throw in the precipitous decline in industry sales and subsequent inventory destocking that occurred in the fourth quarter of 2008. These same intermediaries were unable to reduce their costs quickly enough to avoid experiencing significant losses. (The best of these companies had a handful of products or relationships that subsidized an otherwise uneconomic business model.) During 2009, those bank lending to these distributors reacted as expected—they applied pressure, reduced available credit and increased pricing to match their increased perception of risk. Sound familiar?

The industry must bear the burden of these circumstances now, as virtually all participants rely on only a handful of these distributors. Right now, these companies are starved for cash. They have reduced inventory and a corresponding amount of debt. As demand has returned to a measured degree, many of these companies lack the capital to purchase adequate stocks of materials to regularly supply manufacturing customers. In addition, as so many of the key ingredients are by-products of other markets (e.g., the building materials), which are themselves in the doldrums, core worldwide supplies are low. The limited supply available of a given material is now being bid up by those trying to restock.

We anticipate that material pricing and limited availability will create a difficult environment for the rest of 2010, and that it will remain so throughout 2011. The imbalances that exist just won't work themselves out for some time. This is a new and acute issue for the industry.

These conditions require managers to be creative, intense players of their game. Develop alternative supply channels for key ingredients. Understand the limitations of each of the markets supplying the material. Be very

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aware of the activity levels that could drive supply and demand and affect pricing. More and more frequently, smaller batches are being ordered, manufactured and shipped, reflecting a heightened concern on the part of the purchaser at having to support larger inventory quantities. This being the case, one must make sure that processes adequately support this high throughput activity and that money isn't lost in manufacturing every small batch. On the other side, one must be incredibly good at communicating with clients; visit with them and engage them more than ever. The goal is to be supportive, and to best understand their activities in order to better anticipate their needs and succeed at helping them become successful. This is the equivalent of keeping one eye focused far down the road and the other just over the hood of the car, and in these challenging times, it is likely the most important way to solidify a relationship. Lastly, one should be sure to communicate with other stakeholders; after all, the banker, investor and employees all care deeply about these challenges. It is best to be open about these challenges so that stakeholders can help address them.

Address correspondence to Eric Haley, 119 Fifth Ave. 7th Floor, New York, NY 10003; tel: 1-212-260-2743 x107; eric@corporatefuelpartners.com.